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Paris Minutes Chancellor 2



The analysis in these papers is clear and penetrating: worth reading, especially the second paper.

cc Mr Douglas  
Mr Walker

Treasury Chambers, Parliament Street, SWIP 3AG  
01-233 3000

cc ASD 11.3.80

6th March 1980

msb.

T.L.  
6/3

Dear Tim,

THE BUDGET AND THE COMPANY SECTOR

Your letter to me of 3 March records the Chancellor's undertaking to provide the Prime Minister with a note prepared by Treasury officials showing the substantial shift of resources currently taking place out of manufacturing and into the oil and personal sectors.

I now attach two notes by Messrs Burns and Middleton, the first of which sets out the overall approach, while the second puts some figures on the extent of the transfer from the manufacturing sector.

I should perhaps add that although there is general agreement in the Treasury with the broad thrust of the Burns/Middleton analysis, the balance of opinion suggests that we should not be facing a crisis on the scale of 1974. This judgement seems to be broadly shared by the Bank of England, and liquidity problems have received little attention in representations from the CBI and indeed from industry generally.

As the outline of the Budget which the Chancellor gave the Prime Minister at the end of last week will have indicated, we are tending to the conclusion that there is little we can do on this occasion actually to help the company sector - all we can try to do is to avoid taking action which would add to the difficulties companies will be facing. Moreover there is relatively little in the fiscal field which will be of particular advantage to the manufacturing sector. The best possibility seems to be a reduction in the national insurance surcharge, but we may well find ourselves in the position that we could only afford this in 1980 if it were balanced by additional

/taxation on the

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taxation on the personal sector - and this in its turn would mean either further increasing the real burden of income tax, or adding to the pressure on the price level and so on the level of wage settlements.

*yours*

*John*

A.J. WIGGINS  
Private Secretary

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## TAX MEASURES TO ASSIST INDUSTRY

Note by Mr Burns and Mr Middleton

1. Mr Middleton's minute of 12 February set out the principles which might guide decisions concerning assistance to industry in the forthcoming Budget. This note considers the amount of assistance which might be justified; it should be read in conjunction with the earlier minute.

The Forecast

2. The Treasury forecast shows the company sector moving into an unprecedented deficit - some £8½ bn in 1980-81. Company liquidity declines sharply, recalling the financial crisis of 1974-75. A higher output would bring down the PSBR but would leave the financial problem facing companies much the same. It would still show a sharp fall in companies' gross and net liquidity. This suggests that companies are likely to find themselves squeezed to an extent which could do excessive damage to their productive capacity. Bank lending would remain high and the upward pressure on short term interest rates could continue, even if the general level of interest rates declines.

3. The difficulty is to arrive at the scale of assistance which might be warranted, consistent with maintaining monetary discipline on the company sector. One approach is to ask to what extent the problems, particularly those in manufacturing industry, result from pressures on costs other than those they have suffered as a result of conceding high pay settlements.

The Oil Price Increase

4. The most obvious of these burdens has been the increase in the world oil price. This has hit companies much harder than was anticipated when the Government set its 7-11% target for monetary growth.

5. An increase in the world oil price is just like a new expenditure tax. The Government eventually collects extra revenue from PRT and from parallel rises in the prices of nationalised energy undertakings. This tax is in principle levied on consumers, but its effective

incidence depends on Government policy and the exchange rate.

6. Since the fourth quarter of 1978 the oil price has increased by  $\frac{1}{4}$  a barrel, and the effective exchange rate has risen by 13% with virtually no change in the underlying rate of monetary growth. A very rough estimate of the effect of these two factors is:

a. Consumers lose because oil prices go up - the scale of the oil price increase is about £5 bn. But they are compensated by lower import prices due to the high exchange rate. These roughly offset each other - though on balance consumers are probably a bit worse off.

b. Companies are affected very unevenly:

i. The oil companies gain. They have a permanent benefit of about £1½ bn - the amount they are left with after tax is paid. But because tax is paid late they have a further temporary windfall gain of £3-4 bn.

ii. Non exporting companies also gain - possibly by up to £1 bn - from lower prices of imported capital goods.

iii. The losers are exporting companies who are hit by the high exchange rate. They suffer to the extent of about £5 bn.

c. The Government will benefit eventually by about £3½ bn, but in the next two financial years the revenue is held by the oil companies.

#### Assistance to Exporters

7. This places the Government in something of a dilemma. The obvious course is to try to extract more revenue sooner from the oil sector to pass to the non-oil sector. But oil tax options seem to have been exhausted for the purposes of this Budget - though may be some further thought should be given to seeing if there are ways of bringing forward the tax due on this windfall gain. It is not in the realm of practical politics to suggest that the PSBR should be increased in order to help manufacturing companies - perhaps financed by debt instruments aimed at the oil companies - until the oil revenues accrue. So if it is desired to relieve some of the burden on exporters, there are only two options:

- a. look for revenue elsewhere in the company sector
- b. look for revenue from the personal sector

#### Taxing Non-Exporting Companies

8. There are difficulties in the way of both these options. Some obvious candidates for taxation in these circumstances, such as the banks, who benefit in almost every way from present policies, seem to have been ruled out. And this makes it difficult to contemplate raising large amounts of tax from non-exporting parts of the company sector. Even so, some measures such as VAT blocking, increased VED, the Derv increase - and of course the yield from the PRT increase - could however go some way to financing measures of particular help to exporters.

#### Taxing Persons

9. The scope for taxing persons without large increases in the RPI - which are undesirable for the reasons set out in paras 11 and 12 of Mr Middleton's minute of 12 February - is also limited. The sort of options available are shown in Mr Unwin's minute of 22 February. Even though persons may have been, on balance, a little worse off as a result of the oil price rise, the personal sector has certainly benefitted from the combination of events and policies pursued over the past year. We therefore consider that there is a case for the personal sector contributing to the provision of assistance to exporting companies.

#### The Nature of Assistance

10. The problem which has been identified is one in which exporting companies, and output in general, is suffering from the loss of competitiveness which results substantially from an increase in the world oil price - even though, with North Sea oil, the UK as a whole does not lose real income as a result. Exporting companies, almost by definition, are not the ones who pay substantial amounts of corporation tax - so they cannot be relieved by that route. One scheme under consideration which would help is the Dips Scheme to defer clawback of stock relief. But this does not get to the heart of the problem. All companies have to pay the National Insurance Surcharge. This tax is an imposition on costs, and furthermore it cannot be rebated on exports. If assistance is to be given - as we believe it should be - the best way might be in a substantial reduction

in the NIS together with the Bips Scheme. A 1% reduction would cost £350 million this year and £750 million in a full year. Complete abolition would cost £1½ bn and £2½ bn respectively.

11. There is a further argument for reducing the NIS. Unemployment will increase quite sharply as companies shake out labour in response to the financial difficulties which we envisage. There is little logic in maintaining a tax on employment in these circumstances. Some reduction would ease the situation considerably.

#### Timing

12. The timing of NIS reductions is not ideal. It would not begin to help companies till late in the year. So there is some risk that it may simply be used to finance a further round of high pay increases. This is essentially a matter of judgement. All assistance to companies runs the risk that only employees will benefit, but there are also risks in leaving companies to live with the dual burden of high interest rates and a high exchange rate.

13. Help to companies by the NIS route would not relieve the pressure on bank lending which might continue over the next few months. Indeed, it may cause more companies to bridge the gap before assistance arrives by bank borrowing. This seems to us to be a risk which should be accepted. There is nothing which can be done by fiscal means which will have much effect on bank lending in the immediate future. And there is no way in which we can influence the course of international interest rates. If bank lending does remain very high and if international interest rates do continue to rise, the upward pressure on short term interest rates will be there for some months irrespective of policy action in the Budget.

#### Conclusions

14. Companies are notoriously poor at predicting liquidity crises in advance. In 1974, it was not until they had got into the most serious difficulties that they started to complain. Yet it is a fact that both they and the City are a good deal more optimistic about the future than the forecasters. They may take measures - such as lay offs to ensure that the deficit is not as large as the forecast suggests. But on any view, we think that there will be very strong financial pressure on exporters.

15. Exporting companies have received an arbitrary, unexpected,

decline in competitiveness and profitability because of the exchange rate consequences of the rise in world oil prices. In time market process would bring about an adjustment. But this would be a very painful process in the short term, given that they are also adjusting to a tight monetary policy.

16. To ease this adjustment process, we think that there is a good case for relieving the financial pressure by means of a significant reduction in the National Insurance Surcharge. If the revenue cannot be raised from the oil companies, it will have to come from other companies and persons. We do not think in these circumstances that it would be possible or wise to relieve exporting companies to the full extent that they suffer - but the reduction in the NIS which we have proposed will help them over the next two difficult years. After that, as the medium term financial strategy shows, oil revenues begin to build up in the Government's hands, much of which is on present policies destined to go to persons.

TB/PEM  
22.2.80

Chancellor

c.c. Chief Secretary  
Financial Secretary  
Minister of State (C)  
Minister of State (L)  
Sir Douglas Wass  
PCC  
Mr Eattishill  
Mr Unwin  
Mr Dixon  
Mrs Heaton  
Mr Corlett  
Mr Mortimer  
Mr Seebohm  
Mr Cropper  
P S Inland Revenue  
P S Customs & Excise

TAX MEASURES TO ASSIST INDUSTRY

1. Mr Hall's minute of 11 February to Mr Isaac said that you would like some ideas about measures to assist industry before E Committee. You might therefore find it helpful to have some thoughts on the principles which might guide your decisions in this area.
2. Concern about industry is an aspect of a more general concern about the position of the company sector. This has two aspects:
  - a. Reaching a judgement about the extent of the financial difficulties which companies face.
  - b. The attitude which the Government adopts in the light of this

You will wish to consider (a) when you have an assessment taking into account the forthcoming forecasts. But it can safely be assumed that on any forecast, the position of companies will be poor. So we can examine the considerations which are relevant to fiscal policy decisions against this background.



Monetary Targets

3. The Government's economic strategy depends on :
  - a. Sticking to the monetary targets.
  - b. Ensuring that targets begin to affect the general level of inflation as soon as possible.

Both these considerations are relevant to the question of whether special help should be given to the company sector by means of fiscal relaxations. If the present target is to be maintained, let alone reduced, in the coming year it seems unlikely that there will be any scope for any overall relief in taxation.

4. The first and most obvious point to make is that concessions in one area cannot be financed by a net addition to the money supply. So there have to be offsetting measures elsewhere. These could either be measures which reduce public expenditure, tax increases in other sectors or higher interest rates generally - or a combination of the two. Unless they are accompanied by offsetting fiscal measures, suggestions for tax relief for companies have to be balanced against their interest rate effects. Interest rate effects are very difficult to gauge precisely. Though these may appear small in relation to individual proposals, the cumulative effect can be much bigger than the sum of particular measures. The already unbalanced relationship between the PSBR and interest rates, given the target, would appear to the market to have been worsened - and the market might take interest rates up in anticipation of a heavy funding programme.

5. In deciding whether it wishes to risk higher interest rates or obtain revenue from elsewhere, the second question set out in para 2 is crucial. A tight monetary policy subjects the private sector as a whole to some degree of liquidity shortage. If the pressure to secure large increases in money incomes is great, monetary policy reacts by reducing activity. This is the ultimate way in which it holds back domestic inflationary forces. Some degree of stringency on companies is an unavoidable part of this strategy. The monetary discipline on companies is the only one available on present policies.

6. But monetary discipline has not prevented companies setting wage claims in a particular year which are vastly in excess of the target rate of growth of the money stock. Over the past year, this is exactly what has happened. Companies have been hit by high interest rates, and by the high exchange rate which accompanies a tight monetary policy; their costs have also suffered as a result of the high pay claims they have conceded. So far, companies have been protected by monetary growth in excess of the target; the squeeze seems now to be intensifying and much of it is still to come.

7. The gains - both nominal and real - go to the personal sector. It benefits from the high exchange rate, is not so affected by high interest rates, and of course people receive the pay. Those who lose their jobs receive indexed social benefits. Real incomes have continued to grow over the last year though output has been flat. It is tempting therefore to say that the correct policy is to tax persons and relieve companies.

8. But things are not quite so simple as this:

a. It is important that companies should continue to feel that monetary policy is a discipline. It would not advance the policy much if they were relieved in such a way as to finance a further round of high pay settlements.

b. On the other hand, it is to no-one's advantage to precipitate a financial crisis in companies of the sort we saw in 1974-75 - ie something of such a magnitude as to do great harm to the productive capacity of the economy.

c. The timing of any relief to companies will be important. It is not easy to get money into the company sector. If monetary growth is brought within the target range, companies may have adjusted their operations to the financial difficulties they face. Fiscal relief arriving late in the year may simply finance another high pay round without doing much to sustain an adequate productive capacity.

9. This is one of the crucial judgements which will have to be made in the forthcoming Budget. There must be some degree of pressure on the company sector if the monetary transmission mechanism is to work. This is bound to involve risk to the solvency of some employers.

#### The Scope for Adjustment between Sectors

10. Within a given monetary target, the scope for adjusting the relative burden between sectors is, in any case, not very great:

- a. We do not know very much about the implications of putting more weight on the personal sector for wages and prices. A cut in consumer demand could have a direct effect on prices, although there is not much evidence that markets for finished goods respond at all rapidly. Meanwhile wage-earners might respond to a squeeze on their take-home pay, or even on the cost of borrowing, by pressing for higher pay.
- b. Profits and cash flow are very sensitive to the general level of activity - whether this is seen in the form of consumer goods for the personal or investment demand by the company sector.
- c. The Government's aim to stimulate the supply side of the economy limits the possibilities of using direct taxation to raise revenue from the personal sector.
- d. Indirect tax increases which have a large impact on the RPI, could do much greater damage to monetary policy at this conjuncture than almost any other factor.

#### The RPI

11. This last point requires perhaps a bit of explanation. It follows from the thought in paragraph 5. The extent to which the monetary target has to work through a fall in activity and through financial pressure on companies - depends on the extent to which wage bargainers are influenced by the target.

The more the policy succeeds the more they will be so influenced as financial markets are already influenced. But it is idle to think that people will start taking note of the monetary target to the exclusion of everything else. The most important other influence is probably the perceived rate of price increase. So RPI effects of measures designed to raise additional revenue could be crucial to the policy. The higher the RPI, the higher the nominal level of interest rates and the higher the level of pay settlements. If inflationary expectations are not geared down before the wage negotiations next autumn and winter, the current set of policies could come under such great strain that they would be faced with collapse. There is a limit to the number of short run increases in prices that a given target can stand without the elastic breaking.

12. This does not of course mean that no measures should be taken which have an "impact" effect on the RPI. There are powerful resource allocation arguments for adjusting public sector prices to take account of inflation. And there is also a very strong case for letting energy prices rise an appropriate. But as a general rule in measures designed to raise revenue, where the resource allocation arguments are not strong, the RPI effect must be the dominant consideration.

#### Conclusion

13. The conclusions of this analysis, so far as general help in the Budget to the company sector is concerned, are therefore:
- a. The scope for relieving the company sector is limited by both the need to exert monetary discipline and because of the difficulties of finding alternative ways of raising revenue from the personal sector which do not have an adverse effect on the next round of pay claims, and thus on inflationary expectations and interest rates.
  - b. The extent to which relief can be given depends on finding sources of revenue from the personal sector which

we do not have a strong impact on the RPI. For example, if the personal allowances were less than fully revalorised and the proposed increase in the Vehicle Excise Duty went ahead, this might be used to help the companies - perhaps by financing a reduction in the national insurance surcharge.

c. Timing is likely to be important. It is undesirable to arrange things so we simply finance another high pay round.

More generally, even if it proves difficult to assist companies the aim must be to avoid any increase in the tax burden on business next year.

#### Selective Help

14. Whatever the general position, there is a case for considering changes in the taxation of businesses which are designed to redistribute the existing burden, without great cost, in ways which would help certain kinds of activity. It may be that particular sectors should be singled out: manufacturing industry and traded goods sectors are, for example, more heavily affected by the high exchange rate which accompanies a tight monetary policy. Some measures can be particularly helpful - such as the dips scheme to defer clawback of stock relief - which would help to take the pressure off businesses with tight liquidity or who have to draw down stocks for other reasons eg the steel strike. With a broadly revenue neutral package for industry it might make sense to finance a dips scheme by, for example, increasing the PRT rate by 10 percentage points, or by blocking VAT on the business use of petrol.

15. The enterprise package is another example of a series of measures which will be of particular help to small firms without a large revenue cost. The latest state of play on this package is summarised in Annex A.

P.E. MIDDLETON  
12 February 1980

## ENTREPRENEUR RISE PACKAGE

A Small Firms Measures

1. Venture capital scheme (income tax relief for individuals' capital losses from investment in unquoted companies).

A FASE proposal. Formerly known as "losses" scheme.

2. Retirement annuity contributions: more generous tax relief for the self-employed.

A FASE proposal. Revenue are suggesting going even further.

3. Stamp duty - relief to assist the marketing of unlisted companies.

A FASE proposal.

4. Apportionment of close company trading income.

A FASE proposal.

5. Interest relief for borrowing for investment in family companies.

A FASE proposal.

6. De-mergers.

Probable announcement of a consultative document.

7. Tax deduction for the cost of raising loan finance.

8. VAT registration and de-registration package.

Raising the registration and de-registration limits, roughly in line with inflation. Approved in principle. New to E Committee.

9. Sub-contractors deduction scheme.

Relaxations likely, in light of consultative document. New to E Committee.

B Profit Sharing

No decisions yet - previous E Committee meeting left it to the Chancellor. Possibilities: (a) improving the 1978 limits; (b) something on share options.

C Capital Taxation Measures



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